BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

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| In the Matter of the Appeal of | ) | |
| | ) | No. 90A-1117-TL |
| Merle R. Haggard and Leona Williams | ) | |
| | ) | |

Appearances:

For Appellant: Michael H. Starler, Attorney at Law

For Respondent: A. Kent Summers, Tax Counsel

## O P I N I O N

This appeal is made pursuant to section 19045[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Merle R. Haggard and Leona Williams against proposed assessments of additional personal income tax in the amounts of $19,617, $30,293, and $20,289 for the years 1980, 1981, and 1982, respectively.

[1/] Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the Revenue and Taxation Code as in effect for the years in issue.

The issue to be decided in this appeal is whether appellant Merle Haggard (Haggard) was at risk with respect to a limited recourse note.

Haggard was an investor in a tax shelter structured by Finalco, Inc. (Finalco). Talman Federal Savings and Loan Association (Talman) acquired computer equipment from Honeywell Information Systems, Inc. Then, Finalco purchased the same equipment from Talman on a sale-leaseback basis, with Manufacturers Bank (Manufacturers) providing the financing. Finalco executed a nonrecourse note, and Manufacturers' loan was secured by the equipment plus the lease payments from Talman.

Then, on December 30, 1980, the following transpired: (1) Finalco sold part of the computer equipment at cost ($1,188,751) to Gateway Aviation Holdings, Ltd. (Gateway), and Gateway executed several limited recourse notes as payment therefor; (2) Gateway in turn sold the same equipment to Haggard for $1,188,751. As part payment, Haggard executed a limited recourse note, which is the subject of this appeal, for $1,144,751; and (3) Haggard leased the same equipment back to Finalco. Finalco assigned all its rights and duties under the Talman sale-leaseback transaction to Haggard. Haggard then relieved Finalco of its lease payments in exchange for Finalco's payment of Haggard's obligations to Gateway under the limited recourse note. Paragraphs 3.2 and 6 of the Haggard-Gateway purchase agreement also provided Gateway would cause Finalco to pay and perform all its obligations under the note to Manufacturers and the lease with Talman, or else Gateway would indemnify Haggard for any loss arising from Finalco's failure to pay or perform. Apparently, all payments under the notes were done via bookkeeping entries, as no canceled checks were submitted as requested by the respondent.

Appellants reported losses of $178,307, $275,385, and $184,446 for 1980, 1981, and 1982, respectively, from this transaction. All but $44,000 (Haggard's cash payment) was disallowed as respondent determined Haggard was not at risk. (See Rev. & Tax. Code, § 17599, subd. (b)(4); I.R.C. § 465(b)(4).) When appellants' protest was rejected, this appeal followed.

Generally, an individual may deduct losses and expenses arising from the leasing of depreciable property only to the extent the individual is "at risk" in that activity. (See Rev. & Tax. Code, § 17599; I.R.C. § 465.) A person is "at risk" in such an activity for the amount of cash he contributes, and for any amount he borrows and puts toward the activity for which he has personal liability. (I.R.C. § 465(b)(1)(B).) However, "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." (I.R.C. § 465(b)(4).)

The question of whether a taxpayer is at risk must be determined by looking at economic reality. (Moser v. Commissioner, ¶ 89,142 T.C.M. (P-H), affd. 914 F.2d 1040 (8th Cir. 1990). Moser is followed in the Ninth, Eleventh, and Second Circuits. (See Larsen v. Commissioner, 89 T.C. 1229, affd. 909 F.2d 1360 (9th Cir. 1990), American Principals Leasing Corp. v. United States, 904 F.2d 477, 483 (9th Cir. 1990), Young v. Commissioner, 926 F.2d 1083 (11th Cir. 1991),

and Waters v. Commissioner, 978 F.2d 1310 (2d Cir. 1992).) In fact, the Larsen case was a test case wherein it was found that Finalco's transactions are economic shams and its investors are not at risk for federal income tax purposes.

However, appellants contend the government must conduct a worst case scenario analysis to determine whether a taxpayer is at risk. (See Emershaw v. Commissioner, ¶ 90,246 T.C.M. (P-H), affd. 949 F.2d 841 (6th Cir. 1991).) We disagree, for Emershaw is against the weight of federal authority (including the view of the Ninth Circuit, which has jurisdiction for California), and was criticized by the Second Circuit in Waters v. Commissioner, supra.

With respect to the economic reality test, we note that under this circular transaction, Haggard does not make any out-of-pocket payments (other than his cash downpayment). His obligations under the limited recourse note are met with the rental payments from Finalco. Finalco meets its rental obligations with payments from Gateway and Talman. With the Haggard assignment, Gateway receives its payments under the limited recourse note directly from Finalco, not Haggard. These circumstances lead us to the conclusion that Haggard was not at risk. Moreover, Haggard's note permits the deferral of payments thereunder if rent or other payments from Finalco are late (with mandatory payment of any deferral by December 31, 1991). However, Haggard must be at risk at the close of the tax year before he is entitled to the claimed deductions. (See I.R.C. § 465(a); Alexander v. Commissioner, 95 T.C. 467 (1990).)

Even if we accept appellants' contention that the respondent should consider whether any party in the chain of this transaction might become insolvent, as the Emershaw court did, paragraphs 3.2 and 6 of the purchase agreement essentially eliminate this possibility. These two provisions protect Haggard in the event Talman becomes insolvent. The only other party which is obligated to make payments to Haggard in this transaction is Finalco, but Finalco's solvency is irrelevant because (1) Finalco's rental payments are assigned to Gateway, (2) Finalco's rights under the Talman lease are assigned to Haggard, and (3) Finalco's payments consist of lease payments from Talman (for which the indemnity provision guarantees) and Gateway, Haggard's creditor. Thus, even if Finalco becomes insolvent, there are sufficient funds to satisfy the Gateway obligation.

Accordingly, respondent's action in this matter is sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Merle R. Haggard and Leona Williams against proposed assessments of additional personal income tax in the amounts of $19,617, $30,293, and $20,289 for the years 1980, 1981, and 1982, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 30th day of November, 1994, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Fong and Ms. Scott present.

_____, Chairman

Matthew K. Fong, Member

Windie Scott*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9.

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